

**Management Advisory Report: Additional
Analyses of Employer's Quarterly Federal Tax
Returns Suggest Possible Tax Compliance
Issues**

September 2001

Reference Number: 2001-30-145

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 26, 2001

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

A handwritten signature in cursive script that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Management Advisory Report – Additional Analyses of
Employer's Quarterly Federal Tax Returns Suggest Possible Tax
Compliance Issues

On September 13, 2001, we briefed the Service Center Compliance staff in the National Headquarters on the results of our review. This memorandum transmits our presentation and reiterates that the discrepancies between the amounts employers are reporting on Employer's Quarterly Tax Returns (Form 941) and the amounts they are reporting on Wage and Tax Statements (Form W-2) should be evaluated to determine if they represent any additional tax owed. The full presentation, including our scope and methodology, is included as an attachment.

In a previous review,¹ the Treasury Inspector General for Tax Administration (TIGTA) reported that, for Tax Year (TY) 1998, 491 employers claimed \$5.4 billion less in wages on Forms 941 filed with the Internal Revenue Service (IRS) than they did on Forms W-2 issued to employees and submitted to the Social Security Administration. This was based on a sample of approximately one percent of the Forms 941 filed. The prior report discussed that these employers may have significantly underreported income, Social Security, and Medicare taxes on Forms 941 for TY 1998. The overall objective of our review was to determine if these 491 employers reported significantly less income tax, Social Security, and Medicare taxes on Forms 941 than they did on Forms W-2.

¹ *Opportunities Exist to Identify Unreported Taxes from Employer's Quarterly Tax Returns* (Reference Number: 2000-30-146, dated September 2000).

In summary, the 491 employers reported a net amount of \$86 million less income taxes, approximately \$517 million less Social Security taxes, and \$11 million less Medicare taxes on their Forms 941 than they reported on their employees' Forms W-2.² These additional discrepancies bring into question the accuracy of these employers Forms 941.

In response to the prior TIGTA report, the IRS agreed to use its Combined Annual Wage Reporting program to review the 491 employer cases; the IRS recently began reviewing these cases, and intends to complete the reviews by December 2001. To assist the IRS' review, data requested at our September 13, 2001, exit conference will be provided. This management advisory report is being provided for informational purposes. Since we are making no recommendations, a response to this report is not required. Copies of this report are also being sent to the IRS managers affected by the report.

Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

cc: Commissioner N:C

Commissioner, Large and Mid-Size Business Division L

Deputy Commissioner, Small Business/Self-Employed Division S

Director, Compliance, Small Business/Self-Employed Division S:C

Chief Counsel CC

National Taxpayer Advocate TA

Director, Legislative Affairs CL:LA

Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O

Office of Management Controls N:CFO:F:M

Audit Liaison: Commissioner, Small Business/Self-Employed Division S

² Because employers are required to match the Social Security and Medicare taxes they withhold from their employees, the Social Security and Medicare taxes reported by employers on their Forms 941 should be twice the amount they report on their employees' Forms W-2. We accounted for that requirement in our comparison of the amounts reported.



TIGTA

Additional Analyses of Employer's Quarterly Federal Tax Returns Suggest Possible Tax Compliance Issues

September 2001

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TIGTA

Presentation Overview

- Background
- Objective
- Scope of the Review
- Results

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TIGTA

Background

- The Employer's Quarterly Federal Tax Return (Form 941) is the mechanism that the Internal Revenue Service (IRS) relies on to collect payroll taxes. Under-reporting taxes on Forms 941 benefits an employer because he/she pays less tax.
- Social Security and Medicare programs are funded by taxes withheld and paid by employers.
- Much of the individual income tax the IRS collects is through payroll taxes paid on Forms 941.

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TIGTA

Background (Continued)

- Treasury Inspector General for Tax Administration's (TIGTA) report, *Opportunities Exist to Identify Unreported Taxes from Employer's Quarterly Tax Returns* (Reference Number 2000-30-146, dated September 2000) identified significant discrepancies in the amount of wages employers reported.
 - 491 employers that claimed advanced Earned Income Credit and received a refund, reported \$5.4 billion less in wages on the Forms 941 than on Wage and Tax Statements (Forms W-2).

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Background (Continued)

TIGTA

- In response, the IRS' Combined Annual Wage Reporting program agreed to review the 491 employers to determine if there is underreported and unpaid tax.
- This review was conducted at the Brookhaven IRS Campus in August 2001, in accordance with the President's Council on Integrity and Efficiency's *Quality Standards for Inspections*.

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Audit Objective

TIGTA

- The overall objective of the current review was to determine if these 491 employers reported significantly less income tax, Social Security, and Medicare taxes on Forms 941 than they did on Forms W-2.

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Scope of Review

- We compared the amount of income, Social Security and Medicare tax reported by the 491 employers on Forms 941 to the amount they reported on Forms W-2.
- An employer reports both its share and the employee share of Social Security and Medicare tax on Forms 941.
 - Because an employee's Form W-2 contains only the employee share of Social Security and Medicare tax, we added the employer matching portion to those amounts shown on the Forms W-2.
 - This enabled us to perform the correct match.

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TIGTA

Results

- The 491 employers reported a net amount of \$86 million less in income tax on Forms 941 than Forms W-2.
 - Of the 491 employers, 221 reported \$111 million less in income tax on Forms 941 than Forms W-2.
 - 258 reported \$25 million more in income tax on Forms 941 than Forms W-2.
 - 12 reported the same on both forms.

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Results (Continued)

TIGTA

- Of the 491 employers, 486 reported approximately \$517 million less in Social Security tax on Forms 941 than Forms W-2; 5 employers reported the same Social Security tax on both forms.
- All 491 employers reported less Medicare tax, showing \$11 million less Medicare tax on their Forms 941 than Forms W-2.

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Results (Continued)

TIGTA

- When wage and tax amounts reported by an employer on Forms W-2 issued to its employees are greater than those amounts reported on the Forms 941 filed with the IRS, an employer may have issued more than one Form W-2 to an employee.
 - In this review, approximately two percent of employees received more than one Form W-2. We could not determine if any were issued in error.
- In conclusion, these discrepancies bring into question the accuracy of these employers' Forms 941.

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